No. 82-687

Office - Supreme Court, U.S.
FILED
SEP 12 1983
ALEXANDER L. STEVAS,
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

UNITED STATES OF AMERICA,

Petitioner,

—against—

ARTHUR YOUNG & COMPANY, et al.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE*

KENNETH J. BIALKIN
LOUIS A. CRACO
Attorneys for American Institute of Certified Public Accountants
One Citicorp Center
153 East 53rd Street
New York, New York 10022

Of Counsel:

GREGORY J. GETZ
WILLKIE FARR & GALLAGHER
One Citicorp Center
153 East 53rd Street
New York, New York 10022

QUESTION PRESENTED

The question presented by this appeal, and addressed by the Institute as *amicus curiae* in this brief, may be reformulated as follows:

> Whether sensitive and confidential "tax accrual workpapers," prepared by the taxpayer's independent certified public accountant during the course of an audit of the taxpayer's financial statements, are routinely discoverable pursuant to an Internal Revenue Service summons absent an actual and particularized need for the information contained in those workpapers.

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BRIEF OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE*

PRELIMINARY STATEMENT

The American Institute of Certified Public Accountants (the "Institute") submits this brief as *amicus curiae*, addressed to the issue specified above, and urges this Court to affirm the order of the Court of Appeals for the Second Circuit, entered on April 13, 1982, which reversed the order of the District Court for the Southern District of New York enforcing the Internal Revenue Service ("IRS" or the "Service") summons, to the extent that the District Court order required Respondent Arthur Young & Company ("Arthur Young") to produce the "tax accrual" or "tax reserve" workpapers which it prepared in the course of its audits of the financial statements of Respondent Amerada Hess Corporation ("Hess").[1]

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[1] This brief is submitted upon consent of the parties pursuant to Rule 36.1 of this Court. The written consent of the Petitioner is contained in a

INTEREST OF THE INSTITUTE AS *AMICUS CURIAE*

The Institute is the only national accounting association whose membership is limited to certified public accountants; it has approximately 200,000 members. Among its purposes are the promotion and maintenance of high professional standards of practice and the development of Generally Accepted Auditing Standards ("GAAS").[2] It regularly identifies and addresses issues important to the independent public accounting profession.

Such an issue is presented here. The Service's attempts to seek the production of auditors' tax accrual workpapers has generated tension between the asserted need of the Service to obtain information from these tax accrual workpapers to assist it in sorting through the data in its possession, and the need on the part of public investors, as well as others, for auditors to retain reasonably uninhibited access to the information necessary to conduct a thorough and effective audit of corporate financial statements.

The issue presented by this appeal transcends the individual interests of the particular litigants at bar and is of fundamental concern to the auditing profession as a whole. Its ultimate resolution here will affect the practice of auditors charged with

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letter from the Solicitor General dated August 30, 1983. We are informed that the written consent of both Respondent Arthur Young & Company and Respondent Amerada Hess Corporation is contained in a letter from counsel which Respondent Arthur Young & Company has separately filed with the Court.

2 Generally, GAAS establishes "general standards of conduct relating to the Auditor's professional qualities as well as to the judgments exercised by him in the performance of his examination and issuance of his report." AICPA STATEMENT ON AUDITING STANDARDS NO. 1, § 150.01 (1972). One such judgment is the auditor's opinion that the statements reflect the consistent application of generally accepted accounting principles ("GAAP"). These principles govern the presentation in the financial statements of the transactions, assets and liabilities reflected on the books and records of an entity.

auditing financial statements and with compliance with the Securities Laws.[3]

The Institute recognizes not only the need to protect the confidentiality of tax accrual workpapers prepared by independent auditors, but also the significant public interest in the proper enforcement of the revenue laws and the maintenance of the public fisc. Accordingly, the purpose of the Institute's participation in this case as *amicus curiae* is to present an approach that will accommodate these competing interests consistent with both the law and public policy involved.

The analysis proposed by the Institute in this brief focuses upon the relevancy of the documents summoned by the IRS and resolves the competing interests essentially by balancing the Service's need for production thereof against the hardship that disclosure would impose. The alternative analysis presented in this brief does not conflict with the work product analysis applied by the Second Circuit in support of its decision shielding tax accrual workpapers from the reach of IRS summons power. As will become clear from the following discussion, the underlying policy concerns that prompted the court below to protect the confidentiality of these workpapers are the precise policy considerations that provide the fulcrum for the balancing approach espoused by the Institute.

By proposing a flexible balancing approach focused on relevancy, the Institute does not suggest that the application of a work product privilege to the present facts would be in any way inappropriate. The Institute believes that it would be appropriate and desirable for this Court to adopt either the approach espoused by the court below or the alternative approach presented in this brief. The Institute is cognizant of the existence of considerable authority permitting, if not mandating, the judicial construction of common-law disclosure

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3 As employed herein, the term "Securities Laws" includes the Securities Act of 1933, 15 U.S.C. § 77(a) *et seq.* (1976) (the "1933 Act"), the Securities Exchange Act of 1934, 15 U.S.C. § 78(a) *et seq.* (1976) (the "1934 Act"), and the regulations promulgated thereunder.

privileges under the proper circumstances, and is supportive of the narrow application of a work product privilege to shield the tax accrual workpapers at issue here from the reach of the IRS summons power.

STATEMENT

As a public company, Hess is required to have its books and records audited in accordance with GAAS and pursuant to various rules and regulations issued by the Securities and Exchange Commission ("SEC"). Arthur Young has served as independent auditor to Hess since 1971.

The IRS served a summons (A. 15-16)[4] on Arthur Young in 1978 pursuant to Section 7602(a) of the Internal Revenue Code, 26 U.S.C. § 7602(a) (1976), *as amended by* Act of Sept. 3, 1982, Pub. L. No. 97-248, tit. III, § 333(a), 96 Stat. 622 (1982). ("Section 7602(a)").[5] It sought, *inter alia*, Arthur Young's audit workpapers for the years 1972, 1973 and 1974. Among the audit workpapers demanded was Arthur Young's "tax pool analysis" file for each year.

On the motion by the IRS before the United States District Court for the Southern District of New York to compel production of the various documents summoned, the IRS case manager confirmed that the tax pool analysis file was sought essentially so that in reviewing the Hess books and records, the IRS would have access to "the specific items of questionable deductibility that the taxpayer possibly claimed for the relevant tax years" identified by Arthur Young in the course of its audit. (A. 78). The record is clear that "[t]here is no factual data relating to Amerada transactions in the tax accrual papers which is not otherwise available in the taxpayer's records or in publicly available documents." (A. 31-32, 38).

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4 Citations (A. ____) are to the pages of the Joint Appendix.

5 Section 7602(a) is set forth in its entirety in the Appendix to this brief.

Notwithstanding its extensive familiarity with Hess, gleaned from access to Hess' books and records, Hess' banking records and responses to 398 information requests (A. 40-46, 50, 63-65, 86), the IRS has yet to identify what factual information it still needs and now seeks from the Arthur Young tax accrual workpapers. Instead it has represented that its "agents did not know what they wanted and that they, therefore, needed to look at everything." (A. 25, 83).

Similarly, the Service's position in the district court was that preparation of the records in question by third parties, rather than by the taxpayer itself, "has no relevance to the scope of the summons." (A. 84, 85).

The Decisions Below

Despite these unsupported assertions of relevance and need, the district court enforced the summons with respect to the tax accrual workpapers and other Arthur Young audit workpapers. A divided panel of the court of appeals reversed this determination to the extent that the lower court's order required production of the tax accrual workpapers. The court held that, relevancy aside, "these documents should remain confidential in order to protect the reliability of the independent audit process" unless the IRS demonstrated a compelling need for them. 677 F.2d at 214.

Rather than apply a flexible relevancy concept that would balance the IRS' need for the information sought against the burden disclosure by a third party would entail as a test of relevancy[6], the court, following *Hickman* v. *Taylor*, 329 U.S. 495 (1947), and Rule 26 of the Federal Rules of Civil Procedure, adopted what is in effect a similar approach by formulating an "accountant work product" privilege requiring the

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6 Although the court noted that the particular question of the relevancy of tax accrual workpapers had not yet been decided in the Second Circuit, 677 F.2d at 219 n.8, it nonetheless felt constrained to apply the minimal relevancy standard established in its earlier decisions. *See, e.g., United States* v. *Noall*, 587 F.2d 123 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979) (summons directed to taxpayer).

Service to make the same showing of necessity to obtain production of the documents. Since the IRS had not made the requisite showing in this case, notwithstanding its access to Hess' own books and records and to the bulk of Arthur Young's audit workpapers, the court reversed.

Tax Accrual Workpapers and Their Relationship to the Audit Process

Tax accrual workpapers contain materials gathered or prepared by an independent auditor as part of an audit and concern only the adequacy of a client's provision on financial statements for potential tax liability. They are not prepared in connection with the preparation of the client's tax returns.

Accruals for unpaid taxes are an integral component of the financial statements required to be filed by registrants with the SEC (Section 12 of the 1934 Act, 15 U.S.C. § 78(1) (1976) and Regulation S-X, 17 C.F.R. § 210.1-01 *et seq.* (1982)). Whenever an auditor expresses an opinion on financial statements, he must evaluate the tax accrual of any public corporation. FINANCIAL ACCOUNTING STANDARDS BOARD ("FASB") STATEMENT NO. 5 (1975); AICPA STATEMENT ON AUDITING STANDARDS NO. 1 (1972).

Both the creation of a tax liability accrual and the auditor's opinion of the sufficiency of that accrual entail the exercise of judgment. As part of that exercise, the auditor examines a client's records and interviews a client's personnel or counsel, focusing upon the tax consequences of transactions and the potential liabilities that could be asserted by the Service.

Disputes with the IRS are not uncommon. IRS adjustments, made pursuant to tax audit, arise from numerous causes, including honest differences in opinion and IRS disagreements with the courts. (A. 28-29). The auditor and client attempt to identify such potential differences in opinion as a preliminary matter. (A. 28). The auditor then develops a series of positions that the IRS could take, discusses them freely with corporate personnel (A. 30), reviews the underlying facts (A. 31), discusses those facts with the client (*id.*), forms his own judgment whether the accrual for unpaid taxes is likely to be sufficient to

cover potential liabilities, and then documents the basis for his conclusion in his workpapers. When the auditor has discharged his duties in accordance with GAAS, he may render an unqualified opinion if and only if he is satisfied that the tax accrual is not materially insufficient to cover all tax assessments that probably must ultimately be paid that are capable of reasonable estimation. *See* FASB STATEMENT NO. 5, *supra*.

As this submission will demonstrate, the integrity and effectiveness of the audit process outlined above relies upon the assurance of the confidentiality of these communications and judgments. Access by the IRS to such communications and judgments would impair the auditor's ability to make these evaluations. The record shows, without contradiction:

> Clients would be reluctant to provide necessary information in the area of the tax accruals for fear that the IRS would routinely obtain this information and then indiscriminately challenge every tax position taken by it. The devastating impact of this to the auditing profession and to the primary objective of that audit, the integrity of the financial statements, is obvious.

(A. 32).

The adverse impact of IRS discovery of tax accrual workpapers prompts the Institute's *amicus* participation. The Institute's concern regarding the implications of IRS access to tax accrual workpapers is not limited to the large clients of large accounting firms; it affects any client which has its financial statements audited by independent accountants and files tax returns. The profession is thus keenly aware of and deeply concerned by the increasing reticence that this issue injects into the auditor-client relationship at all levels.

SUMMARY OF ARGUMENT

The task of articulating a standard for determining whether specific information or documentation "may be relevant" to the ascertainment of the accuracy of a tax return under investigation within the meaning of the precise language of Section 7602(a) now finally reaches this Court in the context of the most recent IRS attempt to force independent accountants to disclose sensitive and confidential "tax accrual workpapers" prepared during the course of a mandatory audit of corporate financial statements.

The court below ultimately held that the tax accrual workpapers prepared by Arthur Young were conditionally immune from the reach of IRS summons power based upon the application of an "accountant work product" privilege. This Court should affirm the result. It may reasonably do so on the analysis of the Second Circuit. Alternatively, the Court can resolve the tension of competing aspects of the public interest involved here by use of a similar analysis of the threshold question of whether such documents should be deemed relevant to the Service's investigation of Hess' tax liability in light of policy considerations. This in turn involves consideration of whether the documents should be ordered disclosed when they are sought from a third party and not the taxpayers, when they are sought for convenience rather than out of any demonstrable necessity, and when their production will impede the auditor's ability to function and thereby simultaneously denigrate significant countervailing Congressional policies.

Statutory analysis compels the conclusion, supported by the more carefully considered decisions of the lower federal courts and IRS internal guidelines, that tax accrual workpapers prepared by independent auditors are not relevant to an IRS tax investigation absent an actual demonstration that any transactional information contained therein needed to assess the correctness of the return in question is not otherwise available from the taxpayer's own books and records. This approach accords with a proper effectuation of the Congressional con-

cerns implicit in the enactment of Section 7602(a), and, because it enables the IRS to obtain specified portions of the accrual workpapers upon a showing of true need, comports with the Congressional grant of broad summons authority reflecting the Service's need for reasonably uninhibited access to information necessary to enforce the revenue laws.

Tax accrual workpapers reflect communications conveyed to the independent auditor with a distinct expectation that the information will remain confidential. The independent audit process is a delicate and difficult endeavor due in large part to the great degree of subjectivity involved in the various decisions that must be made during the course thereof. It is the Institute's belief, founded on the experience of its members and on the record in this case, that if the client's personnel and counsel believed that their comments and conjecture would be freely available to examining IRS agents simply for the asking, the open and candid exchange between clients and auditors, so vital to the effectiveness of the already complex audit process, would be inhibited.

Accordingly, and notwithstanding the existence of various independent legal duties that provide incentive for continued minimum compliance with the Securities Laws, the depth and quality of the independent auditor's tax accrual analysis will be impeded if these workpapers are subject to routine disclosure to the IRS. An absolute discoverability rule will make it more difficult for auditors to fulfill their professional duty, in the public interest, of examining and testing the adequacy of tax accruals and may impugn the reliability of the provision for these tax accruals reflected in financial statements. Such a result is unnecessary, for the flexible balancing approach urged by the Institute, which provides for IRS access to specified portions of tax accrual workpapers prepared by independent auditors upon a particularized demonstration of actual need, effectively accommodates the varying interests of the IRS, the taxpayer and the independent auditor without unduly burdening any of those entities.

The decision below should be affirmed.

ARGUMENT

POINT I

NON-TRANSACTIONAL DOCUMENTS SUMMONED FROM THIRD PARTIES DO NOT SATISFY THE RELEVANCY REQUIREMENT OF SECTION 7602(a) UPON A MERE SHOWING THAT THE DOCUMENTS "MIGHT THROW LIGHT UPON" THE CORRECTNESS OF THE TAXPAYER'S RETURN.

A. IRS Summonses are not Self Executing; Congress Required that the Courts Determine the Relevancy of the Documents Sought.

The broad investigative powers vested in the IRS by virtue of Section 7602(a) are not unlimited. Despite the import of its mission, the Service has not yet received from Congress the right to *carte blanche* discovery, even from taxpayers and certainly not from third parties. This Court has itself emphasized that the summons power of the IRS " 'is a limited power and should be kept within its proper bounds.' " *United States* v. *Bisceglia*, 420 U.S. 141, 151 (1975).

In recognition of the inherent danger that "the authority vested in tax collectors may be abused, as all power is subject to abuse", Congress entrusted the enforcement of IRS summonses to the exclusive supervisory responsibility of the federal courts. *Id.* at 146. That supervisory responsibility obligates the courts to scrutinize challenged summonses with care to guarantee that the scope and nature of official demands for evidence comply with the limitations established by the statute and the policy limitations implicit in providing for judicial review. *See id.*; *United States* v. *Powell*, 379 U.S. 48, 57-58 (1964); *Reisman* v. *Caplin*, 375 U.S. 440 (1964).

B. Enforcement of an IRS Summons With Respect to Documents Sought from Third Parties that do not Contain Transactional Information Should be Denied Unless the IRS Demonstrates an Actual and Particularized Need for the Information Demanded.

1. Relevancy Under Section 7602(a) is not Open Ended.

Congress has authorized the Internal Revenue Service to summon the production of "books, papers, records, or other data which may be relevant or material" to an appropriate IRS inquiry. That standard, however, does not suggest that mere speculation as to relevancy will suffice to justify enforcement of an IRS summons under the statute. Rather, a summons pursuant to Section 7602(a) may not be enforced unless "the Commissioner. . .[can] show that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, [and] that the information sought is not already within the Commissioner's possession." *United States* v. *Powell*, 379 U.S. at 57-58; *accord United States* v. *Bisceglia*, 420 U.S. at 146. These standards provide an ample basis for precluding disclosure of the Arthur Young tax accrual workpapers.

2. Tax Accrual Workpapers are not "Books, Papers, Records, or Other Data" Within the Meaning of Section 7602(a).

As in every case of statutory construction, in order to determine if the relief sought is authorized, the inquiry must commence with analysis of the statute itself. *E.g.*, Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COLUM. L. REV. 527, 543 (1947). Here Section 7602(a) limits the scope and nature of the information which the IRS may examine to "books, papers, records, or other data." 26 U.S.C. § 7602(a)(1).

The plain language of the statute thus indicates that the nature of the "books, papers, records" available to the IRS is confined to "data"; it provides no indication that the mental conjecture, speculation and thought processes reflected in the

accrual workpapers and which form the basis for the auditor's opinion as to the adequacy for the client's reserve for taxes are to be discoverable.[7] Although the rule of *ejusdem generis*, long recognized by this Court, *e.g.*, *Mason* v. *United States*, 260 U.S. 545, 553-54 (1923), and by common law, 2A C. SANDS, SUTHERLAND STATUTORY CONSTRUCTION § 47.17 (4th ed. 1973), invites such a construction, no resort to that principle is necessary here for, as a former Commissioner of Internal Revenue has put it, "what comes to mind in the use of that term are items such as books, records and other factual materials—not opinions, projections, conjectures and other thought processes." Caplin, *Should The Service Be Permitted To Reach Accountant's Tax Accrual Workpapers?*, 51 J. TAX'N 194, 199 (1979) [hereinafter Caplin, *Tax Accrual Workpapers*].

A tax audit depends on the gathering of factual information; differing interpretations of that information in light of the Code and regulations are judgmental and the gist of tax litigation. The plain meaning of the statutory language supports the view of the Institute that unlimited access to the tax accrual workpapers need not be afforded. In refusing to require the disclosure of tax accrual workpapers on the record before it, the court below was correct and should be affirmed.

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7 Although not defined by the Internal Revenue Code, the term "data" is generally defined as "factual information" (as measurements or statistics) used as a basis for reasoning discussion or calculation. . . ." WEBSTER'S NEW COLLEGIATE DICTIONARY 286 (1981). The term, moreover, has not been construed by this Court. Although recently asked to consider whether handwriting exemplars constituted "other data" within the meaning of the statutory language in *United States* v. *Euge*, 444 U.S. 707 (1980), this Court did not reach that issue, for it concluded that providing such exemplars was required by the statutory duty "to appear . . . and give such testimony . . . as may be relevant or material to such inquiry" under Section 7602(a). *Id.* at 710-11 n.4. In any event, a handwriting exemplar is clearly factual information rather than conjecture or speculation.

3. Convenience to the Service is an Insufficient Predicate for the Enforcement of a Summons When the Documents Sought do not Constitute Records of Transactions Upon Which Tax Liability is Established.

It similarly follows from the statutory reference to "other data" that the IRS is not entitled to information it seeks for convenience purposes. Numerous lower courts have thus applied the relevancy concept of *United States* v. *Powell* to rule that Section 7602(a) was not intended to permit the IRS to obtain the benefit of the summoned party's research by demanding the documents in which its fruits are contained, merely for the purpose of simplifying the performance of the Service's tasks. *United States* v. *Humble Oil & Refining Co.*, 518 F.2d 747, 749 (5th Cir. 1975); *accord United States* v. *Davey*, 543 F.2d 996 (2d Cir. 1976); *United States* v. *Matras*, 487 F.2d 1271 (8th Cir. 1973); *Mays* v. *Davis*, 7 F. Supp. 596 (W.D. Pa. 1934). As explained by the Eighth Circuit in denying further production of materials additional to the taxpayer's books and records, recognition of convenience as the touchstone of relevancy under Section 7602(a) would provide the IRS with the self-executing *carte blanche* discovery power withheld by Congress:

> [T]he government should not, for the mere sake of its convenience, impose unnecessary burdens on a *taxpayer* in conducting an audit or investigation for tax liability, particularly where, as here, there is no indication of a purpose to escape any tax liability. The term "relevant" connotes and encompasses more than "convenience." Consequently, we are not persuaded to fault the district judge for concluding that the government failed to sustain its burden of proof by alleging a general need for a "road map." *If we were to accede to the government's view, it is difficult to imagine corporate materials that might not contribute to a more comprehensive understanding of the workings of the corporation, and thus, according to the government, be deemed relevant to the tax investigation.*

United States v. *Matras*, 487 F.2d at 1275 (emphasis supplied). The Eighth Circuit's reasoning against imposing unnecessary burdens upon a taxpayer for the mere convenience of the IRS is all the more forceful where, as here, the summons is directed to a third party.

This limitation also flows from the statutory language. Section 7602(a) requires a showing of potential relevance to the subject matter of the inquiry. As explained by Judge Garwood in his concurring and dissenting opinion in *United States* v. *El Paso Co.*, 682 F.2d 530 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716):

> Accordingly, "such inquiry" or "such question" is properly understood as referring to the question of "the correctness of any return" or "the liability of any person for any internal revenue tax." Thus, the section means that the books, papers, records or other data which the Service may summon are only those that it seeks because of their potential relevance to the *correctness* of a return or the *liability* of any person for a tax, as opposed to those the Service seeks merely because they have the potential of facilitating or making more efficient the process of examination.

Id. at 546-47 (emphasis in original) (footnotes omitted); *see also* Note, *IRS Access to Tax Accrual Workpapers: Legal Considerations and Policy Concerns*, 51 FORDHAM L. REV. 468, 479 (1982) [hereinafter *IRS Access to Tax Accrual Workpapers*].

4. A More Substantial Showing of Relevancy Should be Required When Documents are Sought Under Section 7602(a) from Third Parties than is Required When Summonses are Directed to the Taxpayer.

The more carefully reasoned lower federal court opinions have also recognized that judicial oversight is particularly appropriate when IRS summonses are directed to third parties, ruling that the burden imposed upon the bystander requires a fuller and more particularized demonstration of relevancy in

order to obtain enforcement. *E.g.*, *Hubner* v. *Tucker*, 245 F.2d 35, 40 (9th Cir. 1957); *United States* v. *Goldman*, 453 F. Supp. 508, 512 (C.D. Cal. 1978), *aff'd*, 637 F.2d 664 (9th Cir. 1980). These courts have thus required the Service to satisfy the reviewing court that it has a true need for information which justifies the hardship imposed upon the third party through the forced disclosure of the summoned information. *United States* v. *Southwestern Bank & Trust Co.*, 693 F.2d 994, 996 (10th Cir. 1982); *United States* v. *Coopers & Lybrand*, 550 F.2d 615 (10th Cir. 1977); *United States* v. *Humble Oil & Refining Co.*, 488 F.2d 953 (5th Cir. 1974), *vacated*, 421 U.S. 943, *aff'd*, 518 F.2d 747 (5th Cir. 1975); *United States* v. *Egenberg*, 443 F.2d 512, 515 (3d Cir. 1971); *Venn* v. *United States*, 400 F.2d 207, 211-12 (5th Cir. 1968); *United States* v. *Harrington*, 388 F.2d 520 (2d Cir. 1968); *Hubner* v. *Tucker*, 245 F.2d at 41; *Local 174, International Brotherhood of Teamsters* v. *United States*, 240 F.2d 387, 390 (9th Cir. 1956); *United States* v. *Williams*, 337 F. Supp. 1114, 1116-17 (S.D.N.Y. 1971), *appeal dismissed and vacated mem.*, 486 F.2d 1397 (2d Cir. 1972); *In re Carroll*, 149 F. Supp. 634, 637-38 (S.D.N.Y.) (*dictum*), *aff'd*, 246 F.2d 762 (2d Cir.), *cert. denied*, 355 U.S. 857 (1957).

The critical holding in *United States* v. *Coopers & Lybrand*, 550 F.2d 615 (10th Cir. 1977), *aff'g* 413 F. Supp. 942 (D. Colo. 1975), supports this balancing approach. There, the Tenth Circuit affirmed the district court's denial of enforcement of an IRS summons demanding production of an independent certified public accountant's audit program and tax pool analysis file (containing tax accrual workpapers). The district court, in refusing to enforce the summons, emphasized that "considerations of policy and burdensomeness" were relevant in the context of judicial enforcement proceedings and indeed were factors to be weighed against the necessity for and relevancy of the information as averred by the IRS. 413 F. Supp. at 948. In applying that test, the district court found that the IRS had uninhibited access to all transactional documents. *Id.* at 949. It further found that "[t]he information contained in the Tax Pool is conjectural and theoretical", *id.* at 953, noting that these papers generally contain "the worst possible

nightmare" the client can conceive can happen if every assumption on which he based his tax were to go against him in some kind of litigation, *id.*, and presciently observed that production would unnecessarily impede the auditor's ability to perform. *Id.* at 954.[8]

Although virtually every business transaction with a third party is reflected on a corporation's tax return, third parties do not assume responsibility for the accuracy of the return simply by conducting business with the taxpayer; nor are they reasonably to believe that by doing so they will be forced to comply with the same broad IRS discovery power to which the taxpayer is subjected. Third parties should not be forced to bear, as a cost of having done business with the taxpayer, the burden of routine inquiry, especially when the information needed to assess the accuracy of the taxpayer's return is otherwise readily available to the Service from the taxpayer's own books and records. *See United States* v. *Theodore*, 479 F.2d 749, 754 (4th Cir. 1973); *accord United States* v. *Coopers & Lybrand*, 550 F.2d at 621; *United States* v. *Humble Oil & Refining Co.*, 488 F.2d at 963.

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8 The authority of *Coopers & Lybrand* is not diminished by the Second Circuit's decision in *United States* v. *Noall*, 587 F.2d 123 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979), or by the Massachusetts district court's ruling in *United States* v. *Arthur Andersen & Co.*, 474 F. Supp. 322 (D. Mass. 1979), *appeal dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980).

Noall sustained enforcement of an IRS summons to the taxpayer seeking confidential audit reports and related workpapers internally prepared by an employee of the taxpayer, and did not involve consideration of production of tax accrual workpapers or of the constraints upon the independent auditing process inherent in the routine disclosure of such documents.

The First Circuit's decision in *United States* v. *Arthur Andersen & Co.*, *supra*, is likewise not inconsistent with *Coopers & Lybrand*; indeed, the present issue remains open in that circuit. There, Andersen's appeal was dismissed as moot because the firm had produced the summoned tax accrual workpapers for IRS examination rather than stand in contempt of the district court's order. The First Circuit further rejected the appeal by the taxpayer on the ground that the same issue was "so significant" that a case where the documents had already been produced was "in a poor posture to serve as the matrix for a precedent." *United States* v. *Arthur Andersen & Co.*, 623 F.2d 725, 729 (1st Cir. 1980).

The relevance required to support enforcement of an IRS summons should thus properly vary in accordance with the nature of the records or material sought, the party from whom disclosure is demanded, and the Service's ability to particularize a true need for the information sought in order to fulfill its duty of determining the correctness of the return in question. *See* Caplin, *Reflections On I.R.S. Criminal Tax Investigations of Corporations*, 12 CUM. L. REV. 233, 254 (1982) [hereinafter Caplin, *Reflections*]; Comment, *The Creation of an Accountant Workproduct Privilege—Rendering Relevancy Irrelevant*, 57 ST. JOHN'S L. REV. 348, 363 (1983) [hereinafter *Rendering Relevancy Irrelevant*]; Note, *A Balancing Approach to the Discoverability of Accountant's Tax Liability Workpapers Under Section 7602 of the Internal Revenue Code*, 60 WASH. U.L.Q. 185, 203 (1982) [hereinafter *A Balancing Approach*].

5. Balancing the IRS' Need for the Documents Sought Against the Hardship that their Production Would Cause to Third Parties Is Supported by Civil Discovery Cases.

None of this is to say that the IRS is never to gain access to factual information from third parties or is not to perform audits. Upon an appropriate showing, such as, for example, that transactional documents belonging to the taxpayer have been lost or destroyed, balancing the hardship to the IRS and to the third party may result in production of factual portions of tax accrual documents to the IRS. *See, e.g., In re Co-Build Companies*, 77-2 U.S. Tax Cas. (CCH) ¶ 9735 (E.D. Pa. 1977) (taxpayer's internal records destroyed by fire; accountant's records were only available source of information).[9]

9 The record developed below is devoid of any showing by the IRS that it cannot obtain from Hess whatever unspecified transactional information it seeks. Indeed, the district court relied conclusively on the IRS case manager's claim that the tax accrual workpapers would reveal, not transactional information to which the Service is entitled, but "the specific items of questionable deductibility that the taxpayer *possibly* claimed for the relevant tax years." (A. 78) (Emphasis supplied.) *See* 496 F. Supp. at 1156.

The record contains no assertions that the IRS will obtain any factual information as to the deducted items themselves or evidence that Hess acted fraudulently in deducting the items. Rather, the record makes clear that the

Such balancing has its appropriate analogue in cases involving the proper scope of discovery under Rule 26 of the Federal Rules of Civil Procedure. *Upjohn Co.* v. *United States*, 449 U.S. 383, 397-402 (1981). In that context, federal courts regularly weigh the balance of need and hardship. *See, e.g., Centurion Industries, Inc.* v. *Warren Steurer & Associates*, 665 F.2d 323 (10th Cir. 1981) (discovery of confidential business information); *Covey Oil Co.* v. *Continental Co.*, 340 F.2d 993 (10th Cir.), *cert. denied*, 380 U.S. 964 (1965) (same); *Lincoln American Corp.* v. *Bryden*, 375 F. Supp. 109, 112 (D. Kan. 1973) (When "it appears that confidential relationships or established principles of public policy might be unnecessarily compromised. . .such protective power may be used to strike a fair balance of competing interests. . . .") (citations omitted); *Carlson Companies* v. *Sperry & Hutchinson Co.*, 374 F. Supp. 1080, 1088 (D. Minn. 1974) ("[W]hen [discovery] requests approach the outer bounds of relevance. . .the Court must then weigh that request with the hardship to the party from whom the discovery is sought.").[10]

The flexible balancing test advocated here also comports with and is supported by this Court's decision in *Upjohn Co.* v. *United States*, 449 U.S. 383 (1981), applying the work product doctrine to Section 7602(a). This Court emphasized the "strong public policy" which protects against compelled disclosure of the " 'mental impressions, conclusions, opinions

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IRS seeks not additional facts as to specific transactions, but rather a convenient roadmap through the tax accrual workpapers to discover the opinions of Hess' management and Arthur Young as to those items whose deductibility might be questioned by the IRS and speculation by Arthur Young as to the probable resolution of any such items. This, as made clear above, provides no basis for the proper enforcement of a summons and does not outweigh the prejudice to the audit process caused by the production of these workpapers.

10 *See also Carr* v. *Monroe Mfg. Co.*, 431 F.2d 384 (5th Cir. 1970), *cert. denied*, 400 U.S. 1000 (1971); *Mitchell* v. *Bass*, 252 F.2d 513 (8th Cir. 1958); *Doe* v. *United States Civil Serv. Comm.*, 483 F. Supp. 539, 579 (S.D.N.Y. 1980).

or legal theories of an attorney or other representative of a party concerning litigation' " to the IRS. *Id.* at 400, *quoting* Rule 26 of the Federal Rules of Civil Procedure. *See United States* v. *Nobles*, 422 U.S. 225, 236-40 (1975). The Court therefore denied enforcement of the IRS summons which sought production of the results of an internal corporate counsel's investigation as to potentially corrupt payments, ruling that "a far stronger showing of necessity and unavailability by other means than was made by the Government. . . in this case would be necessary to compel disclosure." *Upjohn Co.*, 449 U.S. at 402.

Although the Institute does not contend that *Upjohn* is directly on point, it is nonetheless submitted that, particularly when read in light of *Hickman* and *Nobles*, this Court in *Upjohn* espoused a policy which strongly favors "protecting the taxpayer's expectation of confidentiality and establishing a regimen of fair play between Government and taxpayer." Caplin, *Reflections*, *supra*, at 256; *see also A Balancing Approach*, *supra*, at 206-07.

The balancing approach has an additional analogue in the limitations on discovery permitted in the United States Tax Court. *See, e.g., P.T. & L. Construction Co.* v. *Commissioner*, 63 T.C. 404, 414 (1974) ("[W]hat is relevant is the *factual information*. . . .Mental impressions, legal analysis, conclusions, and recommendations are generally not relevant.") (emphasis in original); *Esson* v. *Commissioner*, 34 T.C.M. (CCH) 586, 587 (1975) (same).

Moreover, in a significant and analogous trend, a growing number of lower federal court decisions have applied this balancing approach to shield critical self-evaluation reports prepared by institutions and individuals from discovery under Rule 26(c), when protection of confidentiality of their contents is required on public policy grounds to encourage the free flow of information. For example, discovery has been disallowed, on balance, with respect to college faculty evaluation reports in order to enable the institution to obtain honest and candid peer review of faculty professors. *Keyes* v. *Lenoir Rhyne College*,

552 F.2d 579, 581 (4th Cir.), *cert. denied*, 434 U.S. 904 (1977).[11] A widely recognized self-critical analysis discovery privilege has thus emerged under federal law that would conditionally shield tax accrual workpapers from discovery under Rule 26(c). Note, *The Privilege of Self-Critical Analysis*, 96 HARV. L. REV. 1083, 1095 n.40 (1983).

C. Enforcement of the Summons Issued Here Violates the Spirit of Internal IRS Guidelines.

The relevancy standard urged here is also supported by internal IRS guidelines, procedures, and pronouncements and any less flexible standard would contradict those internal rules.[12]

Because tax accrual workpapers contain not only the sensitive opinions, conjectures, and speculations received by independent certified public accountants from their clients' personnel, but also those put forward by the auditors themselves, the Institute did not contemplate, when it promulgated its Statements on Auditing Standards, that workpapers prepared pursuant thereto would be routinely available to the IRS for the mere asking. Indeed, the Institute's Federal Taxation Division believed, from discussions with the IRS extending over many years, that the IRS comprehended the importance to the audit process of maintaining the confidentiality of such

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11 *See, e.g.*, *EEOC* v. *University of Notre Dame Du Lac*, DAILY LAB. REP (BNA) No. 166, at D-1 (7th Cir. Aug. 17, 1983); *Emerson Elec. Co.* v. *Schlesinger*, 609 F.2d 898 (8th Cir. 1979); *Reynolds Metals Co.* v. *Rumsfeld*, 564 F.2d 663 (4th Cir. 1977), *cert. denied*, 435 U.S. 995 (1978); *Webb* v. *Westinghouse Elec. Corp.*, 81 F.R.D. 431 (E.D. Pa. 1978); *Bredice* v. *Doctors Hosp., Inc.*, 50 F.R.D. 249 (D.D.C. 1970), *aff'd mem.*, 479 F.2d 920 (D.C. Cir. 1973).

12 While Examination Division guidelines do not apply in joint investigation cases, such as the present one, 1 INTERNAL REVENUE MANUAL (CCH) (AUDIT) ¶ 4024.1 (1981), the court below treated the summons issued in this case effectively as one issued in aid of a civil audit. *See* 677 F.2d at 218. However, it is significant to note that the Examination Division guidelines discussed below were promulgated after the issuance of the summons in this case, and thus are not directly applicable here. They do, however, reflect the Service's own appreciation of the standards governing third-party access and, hence, are instructive.

client information and that the IRS had therefore tacitly agreed to limit its efforts to obtain access to tax accrual workpapers to extraordinary cases.

The IRS Handbook for Special Agents was accordingly amended in 1977 to provide, in pertinent part:

> The inquiry cannot amount to an inquisition or arbitrary inquiry on the part of the tax investigators. A reasonable basis for making the inquiry must exist. What is justifiable "fishing" will be determined from all the facts in each case including the end for which the information is sought. *The investigation must not be an unreasonable burden on the third party whose records are sought.*
>
> In a fraud case, a test as to whether the examination would impose an unreasonable burden is whether the facts show *a reasonable ground of suspicion or probable cause for the examination to ascertain if there has been a fraud*. The burden upon the third party must be considered in relation to the expected degree of success in finding documents bearing upon the tax liability of the taxpayer being investigated.

IRS Manual MT 9900-36 §§ 267.2(5) and 267.51(2) (March 1, 1977) (emphasis supplied) (footnotes omitted).

And with respect to the workpapers of an independent auditor, the IRS issued guidelines requiring the examiner to remember that "the taxpayer's records are the primary source of information and the accountant's workpapers should normally be used only as a collateral source, access to which should be requested with discretion." 1 INTERNAL REVENUE MANUAL (CCH) (AUDIT) ¶ 4024.2(2) (1980). *See also* IRS Information Notice 80-7 (August 4, 1980). More significantly, the director of the IRS Examination Division unqualifiedly directed that opinions or judgments contained in tax accrual workpapers are not relevant to an IRS examination:

> The examiner's interest in the "items" that make up the tax accrual does not include the independent accountant's or taxpayer's opinion of the value of the issues or the

> likelihood of success in litigation, but rather an identification of the undisclosed position taken by the taxpayer.

Id. It is questionable whether opinion can be separated from underlying fact in order that this directive be carried out.

On May 14, 1981 the Service again revised the guidelines, apparently in response to adverse corporate taxpayer reaction to the June 1980 directives. This reaction in part took the form of a palpable reluctance on the part of some corporate taxpayers to cooperate fully with independent auditors due to a perception that the IRS had taken insufficient measures to restrict examining agents' access to confidential accrual workpapers. *See, e.g.*, Buchholz, *Tax Accrual File Controversy: Legal Problems Facing the Accountant*, 40th ANN. N.Y.U. INST. ON FED. TAX'N § 37.04[2] (1982) [hereinafter Buchholz]. Accordingly, the revised guidelines tightened existing restrictions even further, preliminarily establishing a firm policy that tax accrual workpapers should be requested only under "unusual circumstances." I INTERNAL REVENUE MANUAL (CCH) (AUDIT) ¶ 4024.4(1) (1981).

In addition to the various foregoing strictures, examiners are now expressly precluded from requesting accrual workpapers unless the taxpayer audit has been substantially completed, specific issues have been identified, and it is determined that additional facts are needed. *Id.* ¶ 4024.4(2). The new directives not only require the agent to exhaust efforts to obtain the necessary factual information from the taxpayer, but also mandate that he request that the auditor provide a separate analysis (but not necessarily contained in the workpapers) relating to those identifications of the facts prior to seeking access to the auditor's tax accrual workpapers. *Id.* Finally, summonses for these workpapers may not be issued until the agent has reconciled book income to taxable income (Schedule M1), *id.* ¶ 4024.4(4), and obtained the prior written approval of the Chief of the Examination Division. *Id.* ¶ 4024.4(5).

In this case, the IRS has disregarded the spirit of its own general guidelines concerning the limited circumstances under which efforts to obtain auditors' workpapers should be implemented, and has made no attempt to cull the facts it needs to

complete its audit from available sources other than the tax accrual workpapers. The Service's guidelines represent a thoughtful analysis of the proper balance to be attained between the IRS' need for access to information and auditors' need for full and complete disclosure by clients. The Institute submits that the principles expressed in these guidelines should be considered by the Court in determining the scope of disclosure actually required to satisfy the Service's legitimate needs.

POINT II

SUBSTANTIAL POLICY CONSIDERATIONS INVOLVING THE PROFESSIONAL RESPONSIBILITIES OF AUDITORS AND THE NEEDS OF INVESTORS FOR FULL AND FAIR DISCLOSURE IN FINANCIAL STATEMENTS FAR OUTWEIGH THE CONVENIENCE OF ACCESS BY THE SERVICE TO TAX ACCRUAL WORKPAPERS IN THE HANDS OF PARTIES OTHER THAN THE TAXPAYER.

Implicit in the argument as presented thus far is the Institute's firm belief that public policy issues important to both the accounting and auditing profession and to the investing public are enmeshed within the fabric of this appeal. This case does not reach the Court in a simple context arraying private contestants on one side against the IRS as the sole guardian of the public interest on the other. Quite to the contrary, there is at issue here, as the Second Circuit properly elucidated below, a direct clash of public policies which requires recognititon and ultimate resolution by this Court.

Tax accrual workpapers reflect communications made to the independent auditor pursuant to an historically based and traditionally recognized cloak of confidentiality.[13] The record in this case, together with the wealth of scholarly and profes-

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13 This expectation of confidentiality is embodied, for example, in the various ethical codes governing the conduct of the independent public accounting and auditing profession promulgated by the Boards of Accountancy of all fifty states and the District of Columbia.

sional commentary that the dispute in question has generated since the mid-1970's, demonstrate that unlimited revelation of the audit client's comments and conjecture to the Internal Revenue Service's agents will unnecessarily inhibit the open and candid exchange between auditor and client essential to the effectiveness of the independent audit process mandated by the Securities Laws.[14] The auditor's ability to obtain the informa-

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14 *See* quotation from record at p. 7, *supra*. For discussions of the specific policy concern that routine IRS discovery of tax accrual workpapers will substantially impede the flow of accurate financial information from the corporate taxpayer to the independent auditor, *see* IRS ACCESS TO ACCOUNTANTS' WORKPAPERS 53-54, 199 (N.Y.L.J. Law Journal Seminars—Press 1980); Buchholz, *supra*, at § 37.06; Caplin, *IRS Toughens Its Stance on Summoning Accountant's Tax Accrual Workpapers*, 53 J. TAX'N 130, 130 (1980); Caplin, *Reflections*, *supra*, at 246-47, 260; Caplin, *Tax Accrual Workpapers*, *supra*, at 199; Garbis & Struntz, *The Second Circuit's Arthur Young Decision: A Privilege for Tax Accrual Workpapers*, 57 J. TAX'N 66, 67 (1982); Hanson & Brown, *CPA's Workpapers: The IRS Zeroes In*, 152 J. ACCT. 68, 70, 71, 76 (1981); Horvitz & Hainkel, *The IRS Summons Power and Its Effect* [sic] *on the Independent Auditor*, 4 J. ACCT., AUD. & FIN. 114, 127 (1981); Robinson & Stoltenberg, *Privilege and Accountants' Workpapers*, 68 A.B.A.J. 1248, 1249 (1982); Stoltenberg & Robinson, *Enforcement of Summonses in Requesting Accountants' Workpapers*, 60 TAXES 673, 675 (1982); Sumner & Reed, *New IRS Guidelines Are Accountants' Best Hope for Protecting Tax Accrual Workpapers*, 27 TAX'N ACCT. 72, 72-73 (1981); *Rendering Relevancy Irrelevant*, *supra*, at 359-61; Note, *Auditor-Client Work-Product Privilege With Respect to Tax Accrual File: The Arthur Young Case*, 27 ST. LOUIS U.L.J. 437, 439-43 (1983); *A Balancing Approach*, *supra*, at 190, 206-207; Note, *Government Access to Corporate Documents and Auditors' Workpapers: Shall We Include Auditors Among the Privileged Few?*, 2 J. CORP. L. 349, 382-88 (1977); *IRS Access to Tax Accrual Workpapers*, *supra*, at 481-84.

For other general discussions of the tax accrual workpapers controversy, *see* Andrews, *Internal Revenue Service Subpoena Power and Audit Workpapers*, 31 OIL & GAS TAX Q. 440 (1982); Diss & Hanson, *Tax Contingency Audit Workpapers: 1981-1982 Developments, Observations and Proposals*, 14 TAX ADVISER 154 (1983); Diss & Hanson, *Tax Contingency Audit Workpapers: Current Developments, Observations and Proposals*, 12 TAX ADVISER 104 (1981); Fink, *Internal Revenue Summons Power*, 38th ANN. N.Y.U. INST. ON FED. TAX'N ch. 19, 19-6 to 19-10 (1980); Kurtz, *Discussion on "Questionable Positions"*, 32 TAX LAW. 13 (1980); Nath, *Internal Revenue Service Summonses for "Sensitive" Accountants' Papers*, 34 VAND. L. REV. 1561 (1981); Saltzman, *Accountants and the IRS Summons: Recent Develop-*

tion needed to formulate an opinion with respect to the adequacy of the client's accrued tax liability will thus be fundamentally impeded. The resulting effect upon the reliability of the audit process is obvious, as is the identity of the group that will suffer the ultimate harm emanating from this scenario—the investing public.

A. The Breadth of the IRS Summons Power is Appropriately Circumscribed by Strong Countervailing Public Policy Considerations.

While this Court has often emphasized the duty of every citizen to appear and give testimony or produce records when properly summoned by competent authority, *see, e.g.*, *Blackmer* v. *United States*, 284 U.S. 421, 438 (1932); *Blair* v. *United States*, 250 U.S. 273, 281 (1919), it has also recognized the virtue in excusing the performance of this civic duty when an "exemption is grounded in a substantial individual interest which has been found . . . to outweigh the public interest in the search for truth." *United States* v. *Bryan*, 339 U.S. 323, 331 (1950).

The Congressional grant of summons authority to the IRS may indeed be substantial, but that power is no broader than the traditional subpoena authority addressed in *Bryan* and has in fact been characterized as a "limited power." *United States* v. *Bisceglia*, 420 U.S. at 151. Accordingly, the obligation to respond thereto, it is well established, remains subject to the corollary principle, traceable to a 1911 interpretation by this Court, that revenue enforcement provisions must yield when necessary for the protection of more significant concerns. *United States* v. *Chamberlin*, 219 U.S. 250, 269 (1911).

This Court has recently confirmed that the summons power of the IRS is not only subject to appropriate assertions of traditional evidentiary privileges, such as the attorney-client privilege and work product rule, *Upjohn Co.* v. *United States*,

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ments, 7 TAX ADVISER 516 (1976); Saltzman, *What an Accountant Can Do About the Threat of an IRS Summons to Produce His Workpapers*, 17 TAXN ACCT. 208 (1976).

supra, but also that "the claimed enforcement authority of the Service . . . [may be] undercut by contrary legislative purposes." *United States* v. *Euge*, 444 U.S. at 715-16. In upholding the Service's right to compel production of handwriting exemplars from a taxpayer, the Court in *Euge* did not rely solely upon the language of Section 7602(a), nor even upon its own interpretation of the statute. Rather, this Court articulated a balancing test which weighed the necessity of obtaining the handwriting exemplar from the taxpayer against competing "constitutional rights *or countervailing policies enunciated by Congress*." *Id.* at 711 (emphasis supplied).[15]

B. Maintenance of the Reliability of the Audit Process and the Protection of the Investing Public Require that Independently Prepared Tax Accrual Workpapers be Conditionally Immunized from Compelled Disclosure.

The present case poses the very clash between countervailing Congressional policies anticipated but not resolved in *Euge*. These significant policy considerations preclude judicial enforcement of IRS summonses demanding production of independent auditors' tax accrual workpapers. Congress has entrusted to the private sector in the first instance achievement of the public policy of full and fair disclosure explicit in the Securities Laws. Independent auditors, by auditing the financial statements of public companies and informing the investing public through their opinions on these companies' published financial statements, play a central role in attaining

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15 Petitioner cites this Court's decision in *St. Regis Paper Co.* v. *United States*, 368 U.S. 208 (1961), in support of its position that an express mandate of confidentiality in the Securities Laws is a necessary prerequisite to any conditional protection of tax accrual workpapers from general IRS disclosure. That case, however, presented no significant policy issue concerning the protection of a professional relationship from outside incursion in order to maintain the quality of continued compliance with federal reporting and disclosure laws. Thus, *St. Regis* is distinguishable. Moreover, no such limitation on the protection of sensitive information from IRS discovery is to be found in *Euge*, which is this Court's most recent pronouncement with respect to the precise issue here—the scope of the IRS summons power.

that goal. Their opinion, rendered after an examination made in compliance with GAAS, expresses a judgment as to the fair presentation of the financial statements in accordance with generally accepted accounting principles, and is a necessary condition to—indeed, an integral part of—the issuance of a registration statement under the Securities Act of 1933 and the annual filing requirements of the Securities Exchange Act of 1934. Regulation S-X, 17 C.F.R. § 210.1-01 *et seq*.

This role is the result of an elaborate framework developed by the SEC, the Institute and others over time. It contemplates an extensive interaction between the independent auditor and the public company with the dual goals of full and fair disclosure as mandated by the Securities Laws and the promotion of the integrity and objectivity of financial statements.

The interaction between the SEC and the audit profession, developed over time to provide the disclosure needed to effectuate the intent and directives of the Securities Laws and the protection of investors, is jeopardized by forced disclosure of tax accrual workpapers absent a demonstration of a particularized need. It was the perceived need to protect and enhance this interaction that motivated the Second Circuit to deny enforcement of the summons below. 677 F.2d at 219-20.

Similarly, it is the interaction between SEC and auditor and the unique role of the *independent* auditor in the audit process that provides the fundamental and determinative distinction between this case and the decisions in *El Paso*, which required production of internally prepared tax accrual workpapers, and in *Noall*, which involved production of internal auditors' workpapers.[16] The internal auditor is assigned no express role

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16 To the extent the reasoning expressed in *El Paso* could be considered applicable to the independently prepared accrual workpapers at issue here, despite the fundamentally different functions undertaken by independent and internal auditors, the decision in *El Paso* is premised upon a highly suspect analysis. The Fifth Circuit rejected the public policy argument presented here, and adopted by the Second Circuit below, essentially because it believed that the threat of SEC prosecution for violation of the Securities Laws sufficiently dissuaded corporate taxpayers from withholding informa-

in this interaction under the Securities Laws and, moreover, lacks the independence required of an independent auditor to render an opinion in conformity with GAAS. Regulation S-X, *supra*, at § 210.2-01. Internal audit reports are not relied on by the general investing community, whereas independent auditors provide the means through which the private sector fulfills its assigned duty of affording an independent review of financial statements and reports thereon to the general investing community. To perform that function, independent auditors need full and confidential communication with their clients in order to form a judgment as to the adequacy of the accrual for unpaid taxes and render the requisite opinion with respect to the fairness of the financial statements.

By emphasizing the policy concerns that are necessarily raised by any interference with the auditor-client relationship through routine compelled disclosure of tax accrual workpapers to the IRS, the Institute does not mean to suggest that wholesale violation of the reporting requirements of the Securities Laws will eventuate if the position for which Petitioner contends is adopted. Rather, the Institute believes that the chilling effect of such routine disclosure will result in growing reluctance on the part of corporate taxpayers to record candid and thorough accrued tax liability analyses and also to share those analyses with independent auditors. Thus, once it becomes clear that the IRS has an unconditional right to examine

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tion from, and not cooperating with, independent auditors. 682 F.2d at 544. This reasoning is fundamentally at odds with the rationale posed by this Court in *Upjohn* in its refusal to narrow the scope of the attorney-client privilege on the similar ground that corporations facing the risk of criminal liability have an adequate incentive to investigate possible internal wrongdoing even without the protective shield of that privilege. This Court concisely disposed of the contention by noting that the argument "ignores the fact that the depth and quality of any investigations to ensure compliance with the law would suffer, even if they were undertaken." 449 U.S. at 393 n.2. The precise concern identified in *Upjohn* is entirely applicable here, for it is undeniable that regardless of any fear of SEC prosecution, the "depth and quality" of the independent auditor's evaluation of the accuracy of the client's contingency tax reserve will be diminished if these accrual workpapers are subject to routine IRS examination.

the workpapers, corporations and their tax advisers will understandably strive to disclose as little as possible in their written accrued tax liability analyses and supporting documentation, and will be inhibited in discussing anticipated tax litigation. *See* Buchholz, *supra*, at § 37.06; *A Balancing Approach*, *supra*, at 206-207; *IRS Access to Tax Accrual Workpapers*, *supra*, at 483-84; *cf. Hickman* v. *Taylor*, 329 U.S. 495, 511 (1947) ("much of what is now put down in writing would remain unwritten").

Indeed, as the Petitioner's brief makes abundantly clear, a public corporate taxpayer is under a legal duty to submit adequate audited financial statements to the SEC, and penalties for inadequacies provide an incentive to ensure minimum compliance with those reporting and disclosure requirements. Moreover, the auditor is under a professional duty to take exception to materially false or misleading financial statements and to qualify his opinion if inadequate documentation of transactions raises questions in his mind regarding the adequacy of tax accruals in those financial statements. The increasing tension between auditor and client that has developed as a result of the interplay between these conflicting interests and IRS access to tax accrual workpapers was the subject of an auditing interpretation issued by the Institute in March, 1981, which details some of the very troubling informational barriers imposed upon the auditing profession since the tax accrual workpapers controversy first arose. AICPA Auditing Interpretation, *The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals*, 1 AICPA PROF. STAND. (CCH) AU § 9326.06-.17 (1982).

Thus, while various existing legal incentives should ensure continued minimum compliance even in the absence of some conditional immunity from IRS summons power for tax accrual workpapers, it is evident from what has been said so far that both the "depth and quality" of the independent auditor's tax accrual analysis will be impeded and gradually eroded if these workpapers are subject to IRS disclosure in the normal course of every corporate tax audit. See *Upjohn Co.* v. *United States*, 499 U.S. at 392 n.2. Although corporate taxpayers

would initially prepare and provide auditors with minimal information about tax accruals made by the taxpayer in order to obtain an unqualified opinion, the absolute discoverability rule urged by Petitioner will, over time, infect and eventually impair the reliability of the provision for accruals for unpaid taxes reflected in financial statements and make it increasingly difficult for auditors to fulfill their professional duty, in the public interest, of examining and testing the adequacy of those accruals.

Such a result is unacceptable; fortunately, it is also unnecessary. The flexible balancing test proposed by the Institute accommodates all of the various interests involved. The IRS would be entitled to access to specified portions of tax accrual workpapers prepared by independent auditors if and when it was able to make a demonstration of a particularized and identifiable need. At the same time, corporate taxpayers would not be disposed to limit disclosure to auditors to the bare minimum needed to ensure compliance with the Securities Laws, and auditors would simultaneously be able to rely on this uninhibited disclosure in rendering unqualified opinions and would thereby avoid being placed in what is in effect an adversarial relationship with their own clients. There thus exists an accommodating alternative to the absolute disclosure rule proposed by Petitioner which can resolve the tension between the discovery provisions of the revenue laws and the reporting provisions of the Securities Laws in a manner respectful of the policies underlying each.

In this case, and on this record, the utility of the independent audit in the capital formation process and the public policies expressed by the Securities Laws far outweigh the convenience of the Service. Absent a particularized demonstration that the IRS cannot conduct an effective and thorough audit of a corporate tax return without access to the sensitive and confidential information contained in tax accrual workpapers prepared by the independent auditors, this Court should not permit the indiscriminate use of the summons power exhibited in this case.

CONCLUSION

The order of the Court of Appeals for the Second Circuit should be affirmed.

Respectfully submitted,

KENNETH J. BIALKIN
LOUIS A. CRACO
Attorneys for American Institute of Certified Public Accountants
One Citicorp Center
153 East 53rd Street
New York, New York 10022

Of Counsel:

GREGORY J. GETZ
WILLKIE FARR & GALLAGHER
One Citicorp Center
153 East 53rd Street
New York, New York 10022

APPENDIX

Section 7602(a) of the Internal Revenue Code provides in its entirety as follows:

> AUTHORITY TO SUMMON, ETC.—For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary or his delegate is authorized—
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> (1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;
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> (2) To summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Secretary or his delegate may deem proper, to appear before the Secretary or his delegate at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and
>
> (3) To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry.